Accounting guidelines for NQDC - Defined Contribution Plan

As it relates to a for-profit company, the accounting for the nonqualified deferred compensation defined contribution plan is generally made up of two separate categories of entries:

1) **First set of entries.** To account for the deferred compensation as compensation expense and to record the deferred compensation account(s) as a liability.

2) **Second set of entries.** To account for the informal financing of the deferred compensation account using corporate -owned taxable investments or variable corporate-owned life insurance (COLI).

Following is a general discussion of the applicable accounting principles. Please keep in mind that the company should determine, in consultation with its accountant and auditors, the accounting treatment that will be used for financial reporting.

GAAP guidelines

The Financial Accounting Standards Board (FASB) is responsible for establishing non-governmental U.S. Generally Accepted Accounting Principles (GAAP). Effective for accounting periods ending after September 15, 2009, the FASB Accounting Standards Codification (ASC Codification) is the single source of authoritative U.S. GAAP. For convenience, these accounting guidelines include both pre- and post-codification references to GAAP.

Expense and liability

The deferred comp plan accounts are a contractual obligation from the company to pay the plan participants in the future and are treated as a long-term liability. This plan liability is accounted for under “Compensation-General” at **ASC 710-10-25 (APB 12)**.

Corporate-owned taxable investments

If taxable investments are used to informally finance the plan, the company follows “Financial Instruments” at **ASC 825-10-25 (SFAS 159)** to account for these assets. Under **ASC 825-10-25** all realized and unrealized earnings are recognized currently on the income statement. See “Fair Value Measurement” at **ASC 820 (SFAS 157)** for additional disclosure requirements. The sample guidelines assume the use of the fair value method.

Life insurance

If corporate-owned life insurance is used to informally finance the plan, **ASC 325-30-35 (TB 85-4 and EITF 06-5)** entitled “Investments in Insurance Contracts” should be your reference.

Income taxes

The plan liability creates an expense that is deductible for tax purposes only when it's paid to the plan participant. These expenses would be grouped with all other deductible temporary differences to compute the deferred tax asset. This deferred tax asset is accounted for under Income Taxes at **ASC 740-10-25 (SFAS 109)**. A deferred tax **liability** is recognized for temporary differences that result in taxable amounts in future years, such as unrealized gains on corporate-owned taxable assets. These deferred tax accounts are based on **ASC 740-10-25** guidance.

Expense and liability (Compensation-General ASC 710-10-25 / APB 12)

Expense and liability entries	Balance sheet Debit (DR)	Balance sheet Credit (CR)	Income statement Debit (DR)	Income statement Credit (CR)
1. Creating the deferred compensation account				
Salary expense (amount deferred)			$100,000	
Deferred compensation liability		$100,000		
2. Crediting earnings to the deferred compensation account				
Deferred compensation expense			$8,000	
Deferred compensation liability		$8,000		
3. Distributing the deferred compensation liability account to the plan participant and close the account				
Deferred compensation liability	$108,000			
Cash		$108,000		

Tax effects

Tax effects	Balance sheet Debit (DR)	Balance sheet Credit (CR)	Income statement Debit (DR)	Income statement Credit (CR)
1. Nondeductible deferred compensation liability				
Deferred income tax asset	$25,000			
Cash		$25,000		
2. Nondeductible effect of earnings credited				
Deferred income tax asset	$2,000			
Tax expense				$2,000
3. Deductible distribution				
Cash	$27,000			
Deferred income tax asset		$27,000		

Nonqualified distributions only deductible when paid

(1) The plan participant defers $100,000 of current compensation (or the company makes a corporate contribution debiting deferred compensation expense) and the company sets up a deferred compensation liability. For plan participant deferrals, this does not create an additional expense for the company because it would have paid the $100,000 in wages anyway. Since deferred compensation is not currently deductible for taxes, the company owes an additional $25,000 ($100,000 x 25%) in current tax.

(2) Accounting for the earnings credited to the deferred compensation account, assuming a hypothetical 8% rate of return. This cost may be partially or fully offset by the earnings in an underlying asset used to informally finance the plan. The company may book the tax effect of the increase in the deferred compensation account, but since it is not currently deductible it increases the deferred income tax asset.

(3) Paying out the plan participant with cash and closing out the deferred compensation liability account. The payment is currently deductible for taxes, which reverses the deferred income tax asset.

Accounting for the gains on corporate-owned taxable investments
(Financial instruments ASC 825-10-25 / SFAS 159)

Corporate-owned taxable investment entries	Balance sheet DR	Balance sheet CR	Income statement DR	Income statement CR
1. Purchase of mutual fund(s) to informally finance deferred compensation liability account				
Mutual fund(s)	$100,000			
Cash		$100,000		
2. Mutual fund(s) realized earnings				
Mutual fund(s)	$5,000			
Other income				$5,000
3. Mutual fund(s) unrealized earnings				
Mutual fund(s)	$3,000			
Other income				$3,000
4. Sell mutual fund(s) and close account				
Cash	$108,000			
Mutual fund(s)		$108,000		
Tax effects				
1. No tax effect				
2. Tax paid on realized earnings				
Income tax expense			$1,250	
Cash		$1,250		
3. Tax effect of unrealized earnings				
Income tax expense			$750	
Deferred income tax liability		$750		
4. Tax paid on realized earnings				
Deferred income tax liability	$750			
Cash		$750		

Under ASC 825-10-25, both realized and unrealized earnings are recognized in the income statement

Realized earnings create current income tax

Unrealized earnings create a future tax liability

(1) The company uses the plan participant's $100,000 deferred wages (or company contribution) to open a mutual fund account. There is no tax effect.

(2) The mutual fund(s) increases $8,000 of which 25% ($2,000) was *realized* interest, dividend and capital gains distributions and of which 50% of the undistributed gains ($3,000) was *realized* capital gains due to rebalancing. *Realized* gains are currently taxable to the company resulting in additional tax of $1,250 paid ($5,000 x 25%).

(3) The mutual fund(s) increases $8,000 of which $3,000 was unrealized gain (increase in NAV). *Unrealized* gains are credited to current earnings. *Unrealized* gains create a deferred income tax liability, due to $750 in tax being owed at a future time ($3,000 x 25%).

(4) The company sells the mutual fund(s), and deposits proceeds into cash. At this point, the company pays $750 in tax on the realized gains upon sale ($3,000 x 25%).

Accounting for investments in life insurance

(Investments in insurance contracts ASC 325-30-35 / TB 85-4 & EITF 06-5)

Life insurance entries (based on Executive Variable Universal Life insurance)	Balance sheet DR	Balance sheet CR	Income statement DR	Income statement CR
1. Company pays premium into insurance contract				
COLI asset (CSV)	$100,000			
Cash		$100,000		
2. Adjustment to cash surrender value (CSV) in the insurance contract				
Premium expense			$3,000	
COLI asset (CSV)		$3,000		
3. Partial withdrawal of CSV (surrender or loan) and deposit into cash				
Cash	$10,000			
COLI asset (CSV)		$10,000		
4. Plan participant dies at end of year one with $1,000,000 of death benefit				
Cash	$1,000,000			
Non-taxable life insurance proceeds				$913,000
COLI asset (CSV)		$87,000		

Tax effects

1. **No tax effect.** Life insurance premiums are not tax deductible.
2. **No tax effect.**
3. **No tax effect.** Loaned amounts or a return of cost basis from a life insurance policy is non-taxable.
4. **No tax effect.** Proceeds from death benefits are non-taxable.

No tax effects when using corporate-owned life insurance

(1) The company contributes cash into a corporate-owned life insurance policy to accumulate funds to finance future benefit payments.

(2) The cash surrender value (CSV) is accounted for as an asset and offsets the life insurance premium expense.

(3) The company can withdraw money from the CSV in the form of a surrender or loan and deposit into company cash to pay a deferred compensation benefit to a plan participant.

(4) When the plan participant dies, the company receives the death benefit proceeds and recognizes the non-taxable income (the difference between the death benefit and the CSV).

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